

TAX CREDIT 202

HousingIowa

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By

**ANGELA M. CHRISTY
FAEGRE & BENSON LLP
90 SOUTH SEVENTH STREET
SUITE 2200
MINNEAPOLIS, MN 55402
(612) 766-6833
achristy@faegre.com**

Tax Credit 202

- I. NON-RECOURSE LOANS. Loans incurred to provide financing for a low-income housing tax credit (LIHTC) project are often non-recourse.
 - A. Limited Partners cannot receive allocations of losses in excess of their capital account unless they agree to restore a deficit balance or the losses result from allocations of deductions relating to minimum gain.
 - B. Minimum gain only arises when non-recourse debt is secured by the project and it equals the excess of the debt over the partnership's depreciated basis in its property securing the debt.
 - C. Since the LIHTC is allocated in the same manner as depreciation, failure to be allocated losses that include depreciation results in a failure to receive credits.
 - D. If the developer is a non-profit charitable organization, non-recourse financing may be viewed by the IRS as excessive inurement, unjustly benefiting a for-profit investor, putting at risk the tax-exempt status of the developer.
 - E. Limited exceptions to non-recourse:
 - 1) Environmental.
 - 2) Conversion/Theft.
 - 3) Other limited exceptions not creating direct obligation for the debt.
 - 4) Guaranty by the general partner or partnership to complete construction and pay for all construction cost-overruns.
 - 5) Limited letters of credit/cash deposits.
- II. FEDERAL GRANTS. It is important to note that Code Section 42 covers a federal grant for a building or the operation thereof.
 - A. Eligible Basis is reduced by the amount of a federal grant received during any taxable year of the compliance period.¹ Most practitioners do not limit the issue to grants received during the compliance period.
 - B. Examples.
 - 1) HOME Grant.
 - 2) Supportive Housing Program Grant.
 - 3) Hope VI Grant or other comparable program.
 - 4) Community Development Block Grant
 - C. Possible Structures.

¹ Internal Revenue Code § 42(d)(5)(A).

- 1) Restructure grant as loan at AFR. This requires an analysis of the projections as to ability to repay the accumulated debt at the end of the compliance period.
- 2) Reduce basis by amount of federal grant.
- 3) Provide grant to developer (almost always where the developer is a nonprofit) for other than “the building or the operation thereof” (tenant services, etc.).

III. INCOME ISSUES.

- A. A grant may be income when received.
 - 1) Exceptions: grants to partners that are corporations may be contributed to the capital of the corporation, without recognition of grant income.² The corporation may then contribute the funds to the partnership as a capital contribution, without triggering income recognition.³
- B. Forgivable loans may be characterized as current grants.
- C. This problem is not limited to federal grants.

IV. FEDERAL SUBSIDIES.

- A. Unless the taxpayer elects to reduce eligible basis by the proceeds or principal amount of a federal subsidy, a federally subsidized building is not eligible for the 9% credit. A federally subsidized building is only eligible for the 4% credit.⁴
- B. Federal subsidies are:
 - 1) A loan the interest on which is exempt from tax under section 103.
 - 2) Any loan funded in whole or in part with federal funds if the interest rate payable on such loan is less than the applicable federal rate in effect under section 1274(d)(1) as of the date on which the loan was made.⁵
- C. Examples:
 - 1) Empowerment Zone loan.
 - 2) A loan funded with a federal grant to a local governmental entity.
- D. There are various exceptions to or exclusions from the federal subsidies rule:
 - 1) HOME Funds - any loan funded with HOME assistance funds.
 - a) A project with a loan with below market interest funded with HOME funds will be entitled to a 9% credit if 40% of the residential units in

² Internal Revenue Code §118.

³ Internal Revenue Code §721(b).

⁴ Internal Revenue Code § 42(b)(1)(B).

⁵ Internal Revenue Code § 42(i)(2).

each building in the project are occupied by individuals earning 50% or less of area median income.⁶

b) However, the 30% increase in basis under IRC § 42(d)(5)(C) is not available if this rule is used.

- 2) Assistance under the Native American Housing Assistance and Self-Determination Act of 1996 is treated the same as HOME loan.
- 3) Community Development Block Grants (“CDBG”). A loan with below market interest, funded with assistance under sections 106, 107 or 108 of the Housing and Community Development Act of 1974⁷ is not treated as a federal loan.
- 4) Affordable Housing Program (“AHP”) loans made by private financial institutions pursuant to Section 721 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)⁸ are not federal loans.

E. Possible Structures.

- 1) Use federal subsidy for construction loan to be repaid before building is placed in service and before January 1 of first year of credit period.
- 2) Non-Profit Loans
 - a) Government entity makes loan to 501(c)(3) corporation and 501(c)(3) makes loan to limited partnership.
 - b) Sometimes used if funds must be provided to a 501(c)(3).
 - c) At-risk issues have to be considered.
 - d) These loans require careful structuring and this structure may not be possible if loan requirements are tied directly to the project.
- 3) In the past some transactions used federal funds exclusively for acquisition of land and existing building and did not seek acquisition credits. However, this structure is not currently a common practice.⁹

V. INTEREST RATE CONSIDERATIONS.

- A. Characterization as loan or grant. Typical transaction will seek to have the grant characterized as a loan.
- 1) Stated interest rate is one factor supporting a loan.¹⁰
 - 2) Ability to repay loan at maturity.
 - 3) Forgiveness provisions.
 - 4) Default and cure provisions.

⁶ Internal Revenue Code § 42(i)(2)(E).

⁷ Internal Revenue Code § 42(i)(2)(D).

⁸ Treas. Reg. § 1.42-3.

⁹ Private Letter Ruling 200035016.

¹⁰ Private Letter Ruling 9203021.

- B. Purchase Option Price. Higher accrued interest on loans may result in limited partner's tax liability, upon sale, if the limited partner was previously allocated corresponding interest expense deductions.
- C. Deductions.
- D. Capital Accounts

VI. RENTAL RESTRICTIONS.

- A. Low-income units must be rented on a non-transient basis, with initial leases of at least six months.
- B. Single Room Occupancy units are eligible, and may share cooking, eating and sanitation facilities. Month-to-month leases may be used in these units without disqualification as transient housing.
- C. Certain buildings used exclusively for transitional housing for persons of independent living within twenty-four (24) months qualify if they meet certain additional requirements, including separate kitchen and bathroom facilities in the units.¹¹
- D. Certain types of housing are not eligible:
 - 1) Student housing (except for federal, state, or local job training program participants, students receiving AFDC payments, students receiving assistance under Title IV of the Social Security Act, certain heads of household and their children and certain married students).
 - 2) Hospitals, nursing homes, sanitariums.¹²
 - 3) Elderly, retirement or other housing which provides "significant services other than housing" (with some exceptions).
 - 4) Mobile homes not on "permanent foundations."
 - 5) A facility that makes available continual or frequent nursing, medical or psychiatric services is not eligible for the credit.¹³
 - 6) Housing which is not available to the general public.¹⁴ Failure to comply with the Fair Housing Act¹⁵ can result in a loss of tax credits.¹⁶ (Does not exclude a preference for certain categories of tenants, such as elderly, formerly homeless, disabled or other sections of the population which are approved of under Fair Housing Rules.)

¹¹ Internal Revenue Code § 42(i)(3)(B)(iii).

¹² Treas. Reg. § 1.42-11(b)(3).

¹³ Rev. Rul. 98-47, 1998-39 IRB.

¹⁴ Treas. Reg. § 1.42-9.

¹⁵ 42 USC § 3601, *et seq*

¹⁶ Memorandum of Understanding Among the Department of Treasury, the Department of Housing and Urban Development and the Department of Justice, dated August 11, 2001.

- E. Rent – Any charges for services that are not optional must be included in gross rent.¹⁷
- 1) A service is optional if:
 - a) Payment is not required as a condition of occupancy
 - b) A practical alternative exists for tenants (may only apply to meals)
 - 2) There is an exception for any fee for a supportive service which is paid to the owner by a governmental entity or 501(c)(3) organization as part of rent and the payment is not separable.¹⁸

VII. UNIQUE ISSUES IN CONSTRUCTION CONTRACTS.

- A. Partnership owes timing adjuster to the investor if the project is not completed on time.
- B. General Contractor should be responsible for adjusters if General Contractor's delay (rather than slow lease-up) causes the adjuster.
- C. The waiver of consequential damages in the AIA A 201 needs to be deleted. (Paragraph 4.3.10)
 - 1) The waiver really is not mutual
 - 2) The contractor's failure to deliver the project on time can be devastating for the general partner.
- D. A liquidated damages clause can help the parties to understand the scope of the damages resulting from delay (see Exhibit A)
 - 1) Liquidated Damages can be calculated on a project basis or a unit basis.
 - 2) For a project, the daily liquidated damages are usually the annual tax credits divided by 365
 - 3) On a unit basis, the liquidated damages are the annual tax credits divided by the number of units, divided by 365
 - a) This can be particularly appropriate in a multi-building project
 - b) This can motivate the contractor to finish some units earlier which can be to the owner's advantage.
- E. Be careful of drafting the clause for allocated tax credit projects.
 - 1) Remember that the project must be placed in service at the end of the second calendar year after credits are allocated.
 - 2) Daily liquidated damages are useless when all credits are lost.

¹⁷ Treasury Regulation 1.42-11.

¹⁸ Internal Revenue Code § 42(g)(2)(B)(iii).

VIII. YEAR 15 ISSUES

- A. Exercise Right of First Refusal Pursuant to § 42(i)(7) of the Internal Revenue Code.
- 1) Why is 42(i)(7) necessary? – Without § 42(i)(7), the IRS could decide that a partnership that grants a below market purchase option or right of first refusal is not the owner of a project for tax purposes.
 - 2) Who can exercise a right of first refusal? – A qualified non-profit organization, governmental entity or certain tenant organizations.
 - 3) What is the minimum purchase price? – Debt plus federal, state and local taxes resulting from the purchase. Debt incurred within a five year period prior to the sale may be excluded.
 - 4) Option v. right of first refusal – Section 42(i)(7) uses the phrase “right of first refusal” and not option. The IRS has said they mean right of first refusal:
 - a) Someone must make an offer to trigger right of first refusal;
 - b) No rational party would make an offer.
 - 5) What is purchased?
 - a) The real property – no question
 - b) Personal property
 - c) Reserves – spend on capital improvements/maintenance of project in years 14/15
 - d) Accounts Receivable – no usually a major issue
 - 6) Time for exercise – End of the compliance period. The exact term to exercise the right of first refusal is negotiated.
 - 7) Applicability – Section 42(i)(7) is effective for post-1989 credit allocation.
- B. Acquisition of Limited Partnership Interest.
- 1) Fair market value of limited partnership interest may be limited
 - a) Limited transferability
 - b) Limited distributions
 - c) Limited ability to transfer project
 - d) Limited short-term appreciation
 - 2) Avoids property transfer transactional costs
 - a) State deed tax
 - b) Loan assumption
 - c) Title insurance costs
- C. Sale of Property at Fair Market Value
- 1) Debt on the Property
 - 2) Disposition of Reserves

- 3) Remaining Use Restrictions
- D. Transfer (or No Transfer) Pursuant to a Qualified Contract.
 - 1) If not waived, taxpayer can offer project to the state credit allocator pursuant to a qualified contract.
 - 2) A qualified contract is the debt plus the taxpayer's investment in the project (adjusted for inflation not to exceed 5% per year).
 - 3) If the credit allocator does not purchase the project within a year, the taxpayer can convert the project to market rate.
 - 4) Three-year phase-in of conversion to market rate.
- E. Extended Use Agreement.
 - 1) Since 1990 all projects must agree to an extended 15-year low-income period. (Internal Revenue Code Section 42(h)(6))
 - 2) This can be terminated if the state credit allocator does not purchase or find a purchaser to buy pursuant to a qualified contract.
 - 3) The right to terminate the extended use agreement may be waived as part of the tax credit application.
- F. Conversion to Home Ownership – Interface of § 42(i)(7) and the Extended Use Agreement.
 - 1) A purchase by a tenant pursuant to § 42(i)(7) terminates an extended use agreement (Rev. Rul. 95-49).
 - 2) Unclear as to whether this applies to purchase by qualified purchasers other than a tenant pursuant to § 42(i)(7).
- G. Resyndication.
 - 1) Property can be sold to a new partnership and general partner can retain a less than 10% interest.
 - 2) Need a new allocation of tax credits or tax-exempt bonds.
 - 3) Transfer is eligible for the 4% credit and the rehabilitation is eligible for the 9% credit.
 - 4) Most appropriate for projects with deferred maintenance needs.
 - 5) Issues with respect to over-income tenants.
- H. Negotiate with Limited Partner.
- I. Steps to Take to Evaluate Options.
 - 1) Review limited partnership agreement to determine general and limited partner rights.
 - 2) Review any Right of First Refusal Agreement (usually post-1989 projects).

- 3) Review Extended Use Agreement for post-1989 projects.
- 4) Determine fair market value of project.
- 5) Determine exit tax liability for § 42(i)(7) price, if applicable.
- 6) Evaluate available reserves.
- 7) Determine if there are other long-term use restrictions.

IX. TEN MAJOR NEGOTIATION ISSUES IN SYNDICATION.

A. The Price for the Tax Credits

- 1) Generally, the equity contributed to the partnership is based on the negotiated “price” paid for the tax credits projected to be received over the ten year credit period.
- 2) Timing of payments of installments of investor equity will affect the price.
- 3) The perceived risk of completion and successful operation of the project will also affect the price.

B. The Certainty of the Investor Equity

- 1) Type of Investor.
 - a) direct investor (e.g. bank).
 - b) multiple member equity fund.
 - c) single investor equity fund.
- 2) If a Fund: has the Fund Manager located the investors (are they already members of the Fund), have the equity dollars been committed to the Fund, and what are the Fund’s approval requirements?
- 3) If a direct investor: what are the conditions to committee approval of the investment?
- 4) What are the due diligence requirements of the investor for closing?

C. The Tax Credit Adjusters

- 1) When can the investor reduce its anticipated capital contribution?
- 2) What is the basis for the adjustment?
 - a) The credit “price”.
 - b) \$1 for each \$1 reduction in credit.
 - c) \$1 plus investor’s anticipated return for each \$1 reduction in credit.
 - d) \$1 plus:
 - (i) investor’s anticipated return for each \$1 reduction in credit, plus
 - (ii) investor’s tax liability resulting from the receipt of above amount.

- 3) Is there a first year timing adjustment?
 - a) How is it calculated?
 - b) Has the developer taken into account the possibility of deferring the commencement of the credit period to the first day of the next calendar year? If deferred, how will that affect the “price” of the tax credits?
- 4) Is there a “benefit” adjuster?
 - a) Changes in Law
 - b) Upward Adjuster
 - c) IRR Adjuster

D. The Guaranties

- 1) Construction Completion Guaranty
 - a) How long is construction completion?
 - (i) Substantial Completion
 - (ii) Final Completion
 - (iii) Construction Warranty Period
 - (iv) 100% (or less) occupancy
 - (v) Break-even
 - b) Are amounts advanced as loans or non-repayable advances?
- 2) Operating Deficit Guaranty
 - a) Is it limited as to duration?
 - b) Is it limited as to amount?
 - c) Are amounts advanced loans or non-repayable advances?
 - d) What is an “operating deficit”?
- 3) Tax Credit Guaranty
 - a) Is it limited as to duration?
 - b) Is it limited as to amount?
 - c) See discussion of “Tax Credit Adjusters” above.

E. Allocation of Profit and Losses and Distributions of Cash/Fees

- 1) Profits and losses from operation of the partnership.
- 2) Profits and loss upon refinance or sale of property.
- 3) Tax-exempt issues.
 - a) If a partnership has a tax-exempt entity or a tax-exempt controlled entity as a partner and such tax-exempt partner is allocated

partnership items in an allocation which is not qualified, then a portion of the partnership's property will be deemed to be "tax-exempt" use property.

- (i) A tax-exempt controlled entity means any corporation which is not itself a tax-exempt entity, if 50% or more in value of the stock in such corporation is held by one or more tax-exempt entities.¹⁹
- b) Tax-exempt use property is depreciated over a 40 year recovery period.
- c) A qualified allocation is one which has substantial economic effect and the tax-exempt partner must be allocated the same distributive share of each item of partnership income, gain, loss, deduction, credit and basis throughout the tax-exempt's tenure as a partner in the partnership.
 - (i) If, for instance, the tax-exempt partner had a .1% in all items, other than gain, in which it had a 50% interest, 50% of the project would be subject to 40 year depreciation.
- d) The classification of a tax-exempt controlled partner as a tax-exempt entity may be avoided if an election is made under Section 168(h)(6)(F)(ii) to treat income received and gain recognized by the tax-exempt entity from such tax-exempt controlled entity as unrelated business taxable income.
- 4) Respecting Cash Distributions, carefully analyze distributions that are different percentages from allocations.
 - a) Allocation of income without distribution of cash.
 - b) Cash flow fees to the general partner.

F. Removal of the General Partner/Reps & Warranties

- 1) When can the limited partner (or special limited partner) remove the general partner?
- 2) What are the consequences of removal?
 - a) Does the general partner forfeit its general partner interest?
 - b) Does the general partner forfeit any other fees?
 - c) Is the general partner required to make any payments?
 - (i) Anticipated operating deficits.
 - (ii) Unpaid developer fee.

G. Fees

- 1) Fees payable to the limited partner.

¹⁹ Internal Revenue Code § 168(h)(6)(F)(iii)(I).

- a) At closing.
 - b) Annually.
 - (i) Cash flow obligation?
 - (ii) Does general partner guaranty?
- 2) Fees payable to the general partner or its affiliates.
 - a) Developer fees.
 - b) Property management fees.
 - c) Partnership incentive management fees.
 - d) Fee payment issues:
 - (i) Priority of payment.
 - (ii) Tax issues respecting recharacterization as distributions.
 - (iii) Right to withhold/suspend payment of fees.

H. Representations, Warranties and Indemnities of General Partner

- 1) Environmental issues and indemnities.
- 2) Tax credit compliance.
- 3) Insurance requirements.
- 4) Property management.
- 5) Property condition.
- 6) Securities issues.

I. Reserves, Operating Costs and Exit Strategy

- 1) 15 year projections will document projected debt service coverage, which will be a factor in analyzing project reserves.
 - a) If, for instance, the project has 10 years of tax abatement, operating deficits might be projected to arise during the last 5 years of the recapture period.
 - b) The partners should analyze “sizing” the reserves up front, so that there is projected to be sufficient cash to pay operating deficits during the initial 15-year compliance period.
 - c) The projections will project allocations of losses to the limited partner. This will need to be analyzed to confirm whether there is the potential of a credit reallocation, based on losses allocated to the limited partner.
 - (1) Non-recourse lower-tier debt
 - (2) Debt forgiveness
 - (3) Deficit restoration

2. It is important for the general partner to determine the limited partner's anticipated exit strategy at the end of the 15-year compliance period.
 - a) Sale of the project subject to the low-income use restrictions under the project land use restriction agreement for the additional 15 year extended use period.
 - b) Grant of a right of first refusal to a qualified non-profit organization to acquire the project for a price equal to not less than the outstanding principal amount of mortgage debt and federal, state and local taxes attributable to such sale.²⁰
 - (1) Credit deficit payments.
 - (2) Repayments of any other limited partner advances.
 - c) Sale of the project free from the low-income extended use restrictions.
 - (1) This requires notice to the State housing credit agency, giving the agency one year to find a qualified buyer, for a price generally equal to (A) outstanding mortgage debt and (B) investor equity contributions, consisting of cash contributed, plus a return based on cost of living increases, not to exceed 5% per year, minus cash distributed.
 - (2) If no investor is found, the land use restriction agreement terminates.
 - (3) For an up to 15-year period thereafter, there can be no evictions of existing tenants, except for good cause, and the rents for such units shall be Section 42 rents.²¹

J. Project Team

- 1) The limited partner will analyze the experience and track record of the general partner's project team:
 - a) Architect
 - b) Contractor
 - (1) Payment and performance bonds/construction completion letter of credit
 - (2) Guaranteed maximum price contract
 - c) Property Management
 - (1) Section 42 experience
 - d) Tax and real estate counsel
 - e) Accountants

²⁰ Internal Revenue Code § 42(i)(7).

²¹ Internal Revenue Code § 42(h)(6)(E) and Rev. Rul. 2004-82.

f) Developer

- 2) The financial strength of the general partner and the guarantor will be evaluated and project reserves will be sized accordingly.

EXHIBIT A

8.4. Add the following new Subparagraph:

Contractor acknowledges that delays in Substantial Completion of the Work beyond _____ days after the notice to proceed is given by Owner (the Scheduled Substantial Completion Date”) would result in the loss of certain tax benefits to Owner and its Partners which would be difficult or impracticable to fix or ascertain under presently known and anticipated facts and circumstances. Accordingly, the parties hereby agree that if Contractor fails to achieve Substantial Completion by the Scheduled Substantial Completion Date, then Contractor shall pay liquidated damages as follows:

\$_____ per day for the first thirty (30) calendar days (0-30 days) that Substantial Completion is delayed beyond the Scheduled Substantial Completion Date, subject to adjustments of the Contract Time as provided in the Contract Documents.

\$_____ per day for each day thirty-one (31) but less than ninety (90) calendar days that Substantial Completion is delayed beyond the Scheduled Substantial Completion Date, subject to adjustments of the Contract Time as provided in the Contract Documents.

\$1126 per day for each day more than ninety-one (91) calendar days that Substantial Completion is delayed beyond the Scheduled Substantial Completion Date, subject to adjustments of the Contract Time as provided in the Contract Documents and subject to the limitations contained below.

For purposes of this Paragraph 8.4, Substantial Completion shall have occurred when a certificate of occupancy is issued for all the units and if required separately for the common areas. If the Work is not substantially complete by December 31, 200____, Owner shall be entitled to actual damages for damages occurring after December 31, 200____, and liquidated damages for damages prior to that date. Contractor acknowledges that Owner has received an allocation of low-income housing tax credits in the amount of \$_____ per year for ten years for the Project and that Owner and its investor will be substantially damaged by delays which could result in deferral or loss of the low-income housing tax credits.